

The Impact of Ethiopian Accession to the WTO on its Financial Service Sector

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Abbreviations

ATM – Automated Teller Machine

BTA – Bilateral Trade Agreements

CBE – Commercial Bank of Ethiopia

COMESA - Common Market for Eastern & Southern Africa

DBE – Development Bank of Ethiopia

DC – Developing Countries

ECCSA - Ethiopian Chamber of Commerce & Sectoral Associations

EIC – Ethiopian Insurance Company

FI – Financial Institution

FTA – Free-Trade Agreement

GATT- General Agreement on Tariffs and Trade

GATS – General Agreement on Trade in Services

GC – General Council

GDP – Gross Domestic Product

GOE – Government of Ethiopia

GSP – Generalized System of Preferences

IGAD – Inter Governmental Authority on Development

IMF – International Monetary Fund

LDC - least-developed country

MFI – Micro Finance Institution

MFN – Most Favored Nation

MFTR– Memorandum on the Foreign Trade Regime

NBE – National Bank of Ethiopia

NO. – Number

NPL – Non-Performing Loan

RTA – Regional Trade Agreement

UNCTAD – United Nation Conference on Trade and Development

USD – United States Dollars

WTO - World Trade Organization

1 Introduction

1.1 Background of the Study

Ethiopia is the most populous least-developed country (LDC) outside of the World Trade Organization (WTO). It is on the process of accession since 2003 and is expected to complete it by 2015. WTO, which gives different options and privileges than regional integration, bilateral trade agreements (BTAs), and generalized system of preferences (GSP) for LDCs in terms of the accession process and its outcome, will have both positive and negative impacts on Ethiopian economy. Particularly, what the potential implications of acceding to the WTO will be on the financial service sector of Ethiopia is an interesting question since subsequent liberalization commitments will have different impacts on different modes of supply and for different stakeholders i.e. consumers, domestic financial institutions (FIs) and the government of Ethiopia (GOE).

This thesis focuses on the impact of Ethiopian accession to the WTO by analyzing if WTO based financial liberalization in different modes of supply will have a positive impact on Ethiopian financial service sector. Particular attention is given to market access and national treatment matters. The financial services sector, which facilitates financial intermediation, is a key to any properly functioning economy. A healthy and stable financial service is essential for sustainable economic growth. Conversely, instability can have economy-wide effects and can dramatically cause crisis.¹ Especially, in a growing economy that depends on the use and flow of its abundant resources, financial services play a vital role in accelerating trade and investment, where FIs are needed to supply capital, diversify risk and absorb shocks.²

Financial services liberalization generally refers to the removal of discriminatory quantitative or qualitative regulations that discriminate against foreign and domestic financial service providers by limiting market entry or commercial presence.³ It addresses the logistics of moving and trading services by addressing issues including transparency, regulatory

¹ Kassahun(2012) p.217

² Wolla(2013) p.3

³ IMF(2010) p.10

environments, and harmonization of standards with international regulations. It requires changes on the “border” and “inside the border” but mainly the amendment of domestic legal and regulatory provisions.⁴

There are a lot of advantages and risks that can be derived from financial liberalization and thus it is important for governments to carefully handle the process by addressing sensitive issues like how to raise the capacity of domestic FIs, how to minimize risks associated with capital movement, how to direct FIs to address social needs, how to properly regulate the sector etc. For Ethiopia, who ranks as one of the poorest performers in the financial service sector, these questions should be answered during and after the accession process.⁵ Neither staying closed nor liberalizing without proper oversight are long lasting solutions.

Financial services liberalization has special meaning for Africa as most African states, have fragile and rudimentary financial sectors and how to respond to increased competition is their big concern. Moreover, colonial heritage and the interest of trans-national corporations left highly restricted presence of foreign firms.⁶ Most African states are also at the same stage of economic development and produce similar goods and services and hence diversifying their economic base requires linking their outputs with international trading regime which requires effective payment, insurance and finance system.⁷ Ethiopia is no exception. However, while expecting banks to boost the economy by providing funds for trade and investment; insurance companies to minimize the risk of trading and investment and micro-finance to create access to capital for small-scale businesses, the GOE insists that the country is not yet ready to liberalize financial services.⁸ It is also not doing enough to improve the sector.

Ethiopia, whose vision is accelerated and sustained economic growth through industrialization and transformation to middle income nation,⁹ requires enhanced and productive agriculture where finance is at the heart of boosting investment and growth by mobilizing

⁴ Njinkeu(2008) p.8

⁵ The World Bank(2014) p.3

⁶ Asongu(2013) p.131

⁷ Ibid

⁸ Tamene(2014)

⁹ MoFED-GTP(2010) P.7

scarce financial savings from the public and channeling it to productive investments.¹⁰ Thus, sustainable development is difficult, if not impossible, to achieve without vibrant and efficient financial system which is accessible to majority of the population, if not to all.¹¹ As part of achieving membership in the WTO, Ethiopia will be required to make commitments in the financial services sector. As LDC, Ethiopia is likely to be given some flexibility in assuming liberalization commitments. However, it will be asked to agree to some threshold of liberalization, and it is important for Ethiopia to be prepared to undertake commitments and develop a negotiation strategy that protects its interests.¹² In addition, to respond effectively to the requests of WTO members, it is indispensable for the GOE to have thorough information and analyze the potential consequences of liberalization.¹³ Experience shows that WTO accession is almost impossible without opening up the financial sector.¹⁴ Across the main 12 WTO services sectors, acceded LDCs have made the most comprehensive commitments in financial services.¹⁵ Therefore, how to have fine tune financial sector liberalization with the necessary legislative and institutional reforms without at the same time tearing down legitimate regulatory instruments and risk financial collapse is a big challenge.¹⁶ Especially, for LDCs like Ethiopia, whose current financial service sector is closed,¹⁷ it is a daunting but inevitable task to calculate the price of joining the world's biggest trading organization in general and the impact on its financial service sector in particular. I was interested to write on this subject matter because as an Ethiopian I know the problems of Ethiopian financial service sector and believe that it is also up to academicians to find solutions by making researches.

¹⁰ Wolla(2013) p.3

¹¹ ICESDF(2014) p.27

¹² Kassahun(2012) p.209

¹³ Bienen(2014) pp.12-13

¹⁴ Asmelash(2014) p.1 All the countries that joined the WTO in accordance with Article 12 including the 7 LDCs have had to undertake deeper commitments in financial sectors.

¹⁵ Bienen(2014) p.23

¹⁶ Kassahun(2012) p.218

¹⁷ Brenton(2012) p.127 A study made by the World Bank on service liberalization indicated Ethiopia to be the most restrictive of all the 102 countries studied.

1.2 Ethiopian accession so far

Ethiopia participated in the debate on the problem of commodities regulation in 1956. It was one of the countries that responded positively to the 1967 GATT invitation for non-member LDCs to take part in the work of the Trade Negotiations Committee. It has also participated in GATT as an observer since 1984. Such increasingly active participation did not however lead to Ethiopia's immediate membership through the Marrakesh agreement.¹⁸

It was in 1997 that the GOE formally applied to be an observer and to initiate accession negotiations within a maximum period of five years. The General Council (GC) accepted Ethiopia's application and it was represented at ministerial level. However, Ethiopia missed the five-year deadline and sought extension, which was granted in 2002.

Ethiopia then submitted its formal request for accession in January 2003. At its next meeting in February 2003, the GC accepted the application and established a working party.¹⁹

In 2007 Ethiopia submitted its MFTR and that triggered the bilateral questions and answers process. The first working party meeting took place in 2008 and attracted a large number of WTO members that already have trade relations with Ethiopia. The participation of these states got stronger during bilateral negotiations.²⁰

Working Party members have submitted over 300 questions regarding Ethiopian MFTR and the GOE answered those questions in 2008 and 2009.²¹ Until December 2012 the working party has met three times and Ethiopia is now in the process of responding to its fourth set of questions.²² Regarding market access negotiations, Ethiopia has submitted its Goods offer in February 2012 while services offer is still expected.

The private sector in Ethiopia particularly the business community feels that their involvement in the accession process has been limited and had not been in consultation as to their priorities and needs.²³ As the targeted beneficiary of this process, concerns about WTO accession issues need to be done at least in consultation with representatives of the private

¹⁸ Desta(2009) p.345

¹⁹ WTO Accessions: Ethiopia(2014)

²⁰ Desta(2009) p.348

²¹ Kenworthy(2010) p.2

²² Kassahun(2012) p.208

²³ Kenworthy(2010) p.3

sector.²⁴ Addis and Ethiopian Chamber of Commerce are members of the Technical Committee for WTO accession but not represented in the decisive Steering Committee.²⁵

Ethiopian accession has so far taken 11 years. This is because first Ethiopian transition from command to market economy in 1991 and subsequent reform programs were premature and the country was not ready to make multilateral liberalization that was requested by the WTO. After Ethiopia started its accession process, the war with Eritrea (1998-2000) was another reason for the delay. Recently, institutional restructuring at the Ministry of trade and industry (2012) has been another reason. Moreover, the 2005, 2010 and the upcoming 2015 election had protracted the GOE and retarded the pace of the accession process. Finally, fear of risk in the financial service sector is the main reason for deliberate slowdown by the GOE.²⁶

1.3 Methodology

To analyze the impact of liberalization commitments on Ethiopian financial service sector legal and economic yardsticks are needed. Therefore, regulation, capacity building, access to capital and volatility, improving competition, technology transfer and efficiency are used. I chose these parameters because they are also voiced by the GOE and are useful for practicability, credibility and proximity reasons.

I have primarily used relevant national and international legal instruments governing the financial service sector. Secondary sources like annual reports, statistics and scholarly writings are also used. In addition, the experience of recently acceded LDCs (Cambodia, Viet Nam and Nepal) whose case better resembles to Ethiopian reality is utilized. Attempts were made to see the experience of African LDC members to the WTO. However, there was no recently acceded African country whose case could be analyzed to formulate the possible outcomes of the accession process for Ethiopia.

In writing this thesis, I have also faced some challenges. Lack of timely and detailed data on Ethiopian financial service sector was the main challenge. In addition, lack of adequate

²⁴ Kenworthy(2010) p.11

²⁵ Id, p.17

²⁶ Tamene(2014)

literatures on Ethiopian accession to the WTO in general let alone with regard to the financial service sector was difficult. On the other hand, this thesis is about an ongoing accession process and the analysis involves speculation about the negotiation and liberalization commitments that Ethiopia might have. However, little is known from the WTO and the GOE on how the negotiation is going on so far. Therefore, addressing all possibilities of financial sector liberalization scenarios under the WTO and their effect on Ethiopian financial service sector while at the same time identifying the most feasible ones was not an easy task.

1.4 Outline of the thesis

This paper is organized into four parts, the first being this introductory chapter. Chapter two gives a precise picture of Ethiopian financial service sector by focusing on the banking, insurance and microfinance activities. It first analyzes the current reality of Ethiopian financial service, which is one of the poorest in the world, and dominated by the banking sector and public FIs. It also explores the financial regulatory institution i.e. the NBE and shows how its regulatory role is inefficient. It then, shows the laws of the country that govern the financial service sector and their degree of openness which is mostly closed to foreigners with variations among different modes of supply. It also discusses the present financial regulatory practices of the state that set stringent entry, operational and exit requirements.

Chapter three deals with the impact of liberalization commitments under the WTO on the financial service sector of Ethiopia. For this reason, it first identifies the four basic modes of supplying financial services. In addition, the key aspects of GATS for Ethiopian accession are identified. These are, pro-LDCs objectives, market access, national treatment, MFN, transparency, domestic regulation, and payment and transfers. Then, it explores and analyzes potential liberalization commitments on different scenarios under each mode of supply. It explains, compares and contrasts these commitment scenarios starting from the status quo (closed scenario) towards broad liberalization possibilities by considering the necessary legal and economic changes. Finally it highlights that the GOE, while acceding to the WTO, should simultaneously address corruption; encourage competition; sequence

measures properly; utilize RTAs, BTAs and GSPs; involve the private sector; and make the NBE focus on regulatory tasks than commercial activities. The last chapter concludes.

2 Ethiopian Financial Service Sector

2.1 Defining financial Services

“Financial Services” generally refer to services provided by organizations (direct finance institutions or financial intermediaries) that deal with the investment and management of money for commercial and retail customers. They refer to any service of a financial nature, which is governed by a measure maintained by authorized party or public body with regulatory power.²⁷ Examples are banks, investment funds, insurance companies, microfinances, estate, trust, agency, securities and stock brokerages.²⁸

Financial services are defined in the GATS’ annex as "any service of a financial nature offered by a financial service supplier", excluding those "services supplied in the exercise of governmental authority", which includes "activities conducted by a central bank or monetary authority or any other entity in pursuit of monetary or exchange rate policies". It is one of the 12 categories of services with 16 subsectors of its own.²⁹

Ethiopian laws³⁰ do not define “financial services” but only illustrate FIs that are governed by them. Accordingly, insurance, bank, micro-finance, postal saving, money transfer or other similar institutions as determined by the NBE are FIs in Ethiopia.

2.2 Ethiopian Financial Service Sector in a Nutshell

Financial service sector consists of users, providers of financial services, regulatory laws and regulatory institutions.³¹ Ethiopian financial service sector was reborn in 1991 with the demise of command economy and the introduction of free market economy in Ethiopia. However, with no capital market and limited shares of private companies, it remains to be one of the least developed sectors in the world.

²⁷ Investopedia Online Dictionary(2014)

²⁸ Deloitte Center for Financial Sector(2014)

²⁹ Ghebregergs(2013) P.20

³⁰ See Banking Business Proclamation art 2(9); Insurance Business Proclamation art 2(12); Micro-Finance business proclamation art 6; and NBE establishment (amendment) Proclamation art 2(10)

³¹ Stern(2007) p.viii

Ethiopia has a population of 87 million and a GDP of 46.87 billion USD³². The service sector shares 46.1% of the GDP while the financial service sector roughly accounts for 5%. The financial sector is dominated by the banking industry and public FIs.³³ (See table 1).

2.2.1 Banking

The banking system in Ethiopia consists of a central bank-NBE and Commercial banks.³⁴ Despite the increase in the number and size of private banks and the restructuring of state-owned banks, the sector is still dominated by the commercial bank of Ethiopia (CBE).³⁵ (See table 1).

Domestic sources (trade and agricultural sectors), particularly from private enterprises remained important sources of saving.³⁶ Accumulation of large excess liquidity with considerable variation across banks is another feature in Ethiopian banking (See table 1). It was particularly high among public banks due to rigid and tightened collateral-based lending practices and inefficient loan delivery systems. This has, nevertheless, recently been improving to the extent that some private banks face shortage.³⁷

With the exception of 2001/02, the banking system and each individual bank have been profitable each year since 1997/98. Interest is an important source of income. Currently interest rates on deposits, which are subject to a floor set by the NBE, stood 5% while lending rate which is fully liberalized stood at 8.0% for public banks and approximately 1% higher for private banks.

Banking services coverage in Ethiopia is far below international as well as African standards with low population-to-bank-branch ratio (See table 1). Only 20% of households and 5% of the rural population have bank accounts or only 14% of adults have access to credit.³⁸ Consequently, the number of formal banks' customers is less than 25% of the total

³² 1USD=20.05 ETB, on Nov.1, 2014

³³ NBE Annual Report(2014) p.1 and ECCSA(2013) p.32

³⁴ Id, p.62

³⁵ NBE Quarterly Bulletin(2014) p.6

³⁶ NBE Annual Report(2014) p.62

³⁷ Id, p.7

³⁸ World Bank(2014)

population, leaving 75% of the population outside of the formal banking sector.³⁹ Simply, Ethiopia has one of the lowest financial inclusion-ratio in Sub-Saharan Africa.

Ethiopian banking sector is characterized by high urban concentration of branches and low rural banking density (See table 1). The banking sector so far has focused on ‘corporate’ finance. Furthermore, credit allocation is skewed towards short-term loans and large-scale trade finance in urban areas with a primary objective of private returns.⁴⁰

Money and capital markets are not developed and securities markets do not exist in Ethiopia except regular market for treasury bills. Government bonds, which are dominated by state institutions, are occasionally issued to finance fiscal deficit and to absorb excess liquidity. Inter-bank money market operation is very low and rediscount facility is available although no bank has so far resorted to this facility due to the existence of excess liquidity (See table 1).⁴¹

The efficiency of NBE’s supervision capacity is weak and the banking infrastructure is poor. The payment system is rudimentary. It mainly provides basic commercial banking products. Innovative products hardly exist and even common services like credit cards, ATMs, mobile and Internet banking have been introduced not long ago.⁴² The banking sector remains uncompetitive, inefficient and incapable of improving the intermediation of private sector savings.

Generally, Ethiopian banking sector has shown increasing performance over the past twenty years with proliferation of actors and services, and increasing profit and growth-rate. Nevertheless, a number of weaknesses are still evident. The accessibility, quality and portfolio of banking services remain limited. Ethiopian banking industry is monopolistically competitive as larger banks are better in their ability to generate more revenue.⁴³ In terms of contestability, the sector is incontestable as entry is difficult due to legal, technological

³⁹ Salah(2014) p.34

⁴⁰ Bezabeh(2014) p.34

⁴¹ NBE Annual Report(2014) p.75

⁴² Stern(2007) p.14

⁴³ Salah(2014) p.30

and economic factors.⁴⁴ Besides, information and communication facilities like Ethio-telecom, which are essential for financial service development, are exclusively held by the state, inaccessible and very poor in quality.⁴⁵

A micro-data analysis from the annual reports of each bank shows the inefficiency of public banks as they have higher cost, smaller interest-spread and lower return of asset.⁴⁶ In addition, there is an implicit policy that public enterprises and government institutions deposit their funds and circulate their financial transactions in public banks. Similarly, the development bank of Ethiopia (DBE) lends capital selectively to firms in sectors the government wants to promote. Moreover, the NBE requires private commercial banks to buy government bonds worth 27% of their loan disbursements with 3% interest rate that resulted in tight and expensive credit system for consumers.⁴⁷ There is also a strict limitation on the investment activities of FIs in other FIs and financial activities.

⁴⁴ Eshete(2013) p.175

⁴⁵ Internet use stood at 8 per 1000, second from the bottom among COMESA members, and 97.8% of the population is still offline

⁴⁶ Kapur(2012) pp.5-6

⁴⁷ Bezabeh(2014) p.26 i.e. Ethiopian measure is estimated to divert about ETB 11 billion (2.4 percent of GDP) from the private to the public sector to cover the government budget deficit.

Table 1 Summary of Ethiopian FIs' Reality in 2014⁴⁸

	Bank			Insurance			Microfinance
	Total	Public	Private	Total	Public	Private	
Share in the financial service sector in %	80			5			15
No. Of institutions	19	3	16	17	1	16	31
No. Of branches	2108	(46.2%)	(53.8%)	323	(17.5%)	(82.5%)	1244
Accessibility	20 million deposit customers and 500,000 loan customers (25% of the population)	(CBE 7 million account holders)	-	400,000 clients	-	-	3.6 million clients (This covers 15% of total households or 20% of the total demand)
Concentration	52% in eight major cities (Addis Ababa 33.8%)	-	-	Addis Ababa 54.8%	-	-	60% in regional states (Addis Ababa 40%)
Population-to-branch ratio	1:41,088	-	-	1:269,300	-	-	1:69,935
Asset in USD	165.3 billion	(70% (CBE 60%))	(30%)	339.1 million	(18.9%)	(81.1%)	1.1 billion
Capital in USD	1.27 billion	(46.1% (CBE 35.3%))	(53.9%)	94.7 million	(21.5%)	(78.5%)	224.4 million
Loan disbursement in USD	6.72 billion	(45.2%)	(54.8%)	239.4 million (Gross market premium)	-	-	708.2 million
Fresh loan disbursement in USD	2.7 billion	(61.3%)	(38.7%)	13.4 million (Total claims paid)	-	-	224.4 million
Saving deposit in USD	11.77 billion (65.7% by CBE)			11.3 million (Total claims outstanding)	-	-	508.7 million
New loan disbursement ratio to total deposit	-	20.7%	27.4%	-	-	-	44.1%
Outstanding credit in USD	8.2 billion	52% claim on state enterprises and cen-	95.4% claim on pri-	-	-	-	134.7 million

⁴⁸ NBE Annual Report(2014) and NBE Quarterly Bulletin(2014)

		tral govern- ment	vate enter- prise				
Domestic sources of loan	90.1% (Private sources of loan 77%)			97% general insurance business	-	-	60% from commercial banks and donors
Important sector	-	Agriculture 84%	Trade sector 68%	Life insurance 11.4%	-	-	Production and petty trade ⁴⁹
Profit in USD	453.8 million (52% from interest)			Non-operational income 30%	-	-	-
Inter-sector interaction	23 inter-bank money market and 0 redis-count facility since 1997			No reinsurance service by local insurance	-	-	-

⁴⁹ Bezabeh(2014) p.28

2.2.2 Insurance

Currently, there are 17 insurance companies in Ethiopia with high concentration in urban areas especially in Addis Ababa.⁵⁰ The NBE has also licensed 1054 insurance agents, 26 insurance brokers, 19 loss assessors, 19 loss adjusters and 1 actuary. Private insurance companies in Ethiopia emerged after the 1992's liberalization measures.⁵¹ Their share is higher than public institutions and increasing through time even though EIC is the largest player in the sector.⁵² (See table 1).

Insurance business activities are classified into direct, indirect and auxiliary services all of which are available in Ethiopia with the predominance of the first. The Ethiopian insurance market is characterized by small risks. (See table 1). Large commercial and industrial risks are rare and mostly transferred to foreign insurance companies. However, as of May 1, 2014, the NBE allowed reinsurance in Ethiopia to enable domestic insurance institutions expand their underwriting capacity,⁵³ minimize their cost and dependence on foreign FIs, and save foreign currency.⁵⁴

Although the share of life insurance in gross-premium has grown steadily, it is still very low and that is because of its long-term nature that requires higher degree of consumers' confidence. Insurance companies' investment activities are heavily constrained by lack of infrastructure, especially a stock market, and by the restrictions imposed by the NBE that requires them to invest majority of their funds in government securities at negative real interest rates.

Generally, the development of the insurance sector in many ways resembles that of the banking sector with increasing profit and private sector participation. (See table 1). The range of insurance products is limited. Besides, premium setting is based on outdated methods, and there is lack of risk assessment methodologies. The regulation of the sector is also ineffective. However, contrary to the banking sector, competition is stiff in the insu-

⁵⁰ NBE Quarterly Bulletin(2014) p.6

⁵¹ Ibid

⁵² Asegedew(2013) p.7

⁵³ Salah(2014) p.4

⁵⁴ Directive No.SRB/1/2014

rance industry. Private insurance companies' involvement is better and they are ambitious to increase their sales volume and customer base, which often causes aggressive pricing policy that led to an unhealthy spiral of premium cutting.⁵⁵

2.2.3 Microfinances

Limited accessibility of banks and high demand for access to finance increases the necessity for Microfinances in Ethiopia whereby commercial banking is complemented by 31 micro-finance institutions (MFIs). The GOE has a huge hand in MFIs as their goal is not only generating profit but also to fulfill a social objective of incorporating the poor strata (mainly rural) of the population into the banking system by creating subsidized low rate lending and improving pervasive poverty lending.⁵⁶

However, the microfinance sector in Ethiopia has low competition as most of the MFIs are considerably smaller while four major public MFIs dominate the asset, capital, saving and credit of the system.⁵⁷ (See table 1). Even if MFIs in Ethiopia are meant for rural consumers who have limited access to banks, they are also concentrated in major cities. (See table 1). However, the urban-oriented MFIs have not yet been effective in alleviating capital shortage and credit access limitations that inhibit the expansion of medium and small-scale enterprises.⁵⁸

2.3 Regulation of the Financial Service Sector

2.3.1 Laws

Ethiopia is a federal state with a parliamentary system of government. Looking at the legal system of the country, it follows a civil-law legal system and the Federal constitution is the supreme law of the land followed by proclamations enacted by the parliament; regulations made by the council of ministers; and directives made by lower organs of the state, respectively. International treaties ratified by the state are also integral parts of the law of the land

⁵⁵ Stern(2007) p.xiv

⁵⁶ Ayele(2014) p.11

⁵⁷ Asegedew(2013) p.19

⁵⁸ Id, p.21

and are parallel to proclamations. Ethiopian laws, especially directives issued by the NBE, play a key role in the regulation of the financial service sector. The NBE has issued more than 68 Directives so far. Ethiopia has also concluded more than 58 trade agreements (29 bilateral) that are relevant for regulation of the sector.⁵⁹

Ethiopian laws provide the following regarding the four modes of financial service supply. Cross-border supply of financial services is permitted for reinsurance where Ethiopian insurance companies can buy reinsurance services from foreign insurance companies subject to a limitation to be set by the NBE. Cross-border banking services are also limited to borrowing from abroad by the government, some state-owned enterprises (e.g., Ethiopian Airlines), and exporters (without a government guarantee of foreign exchange availability).

There is no prohibition on ‘consumption abroad’ of financial services, as long as such purchase of services complies with foreign exchange regulations. The same is true for Mode 2 sale of financial services, i.e., consumption of financial services by foreigners while they are in Ethiopia.

Regarding commercial presence, financial services are exclusively reserved for Ethiopian nationals (natural and juridical persons). Foreigners are prohibited from operating FIs in Ethiopia fully or partially.⁶⁰

Concerning the temporary movement of natural persons, the NBE has foreseen the possibility to authorize consultants, actuaries, surveyors, loss assessors and loss adjustors that have already been licensed abroad to give such services in Ethiopia.⁶¹

2.3.2 The Regulator

There are two distinct but complementary policy discussions on the role of government in broadening and deepening access to finance; the modernist approach- which advocates for market mechanism in allocating financial resources- and the activist approach that calls

⁵⁹ UNCTAD(2013)

⁶⁰ Micro Finance Business proclamation art 25; Banking Business proclamation art 9; and Insurance business proclamation art 10

⁶¹ Stern(2007) p.99

governments to play active role in promoting the breadth and depth of financial services.⁶² Particularly in DCs, the latter approach is common with restrictive legal and regulatory frameworks that aim at avoiding reckless and corrupt practices. Effective financial sector policy combines both approaches in a context-sensitive manner.⁶³ The GOE favors the activist approach as evidenced from the speech of former Ethiopian Prime Minister. He said that neo-liberal paradigm and associated economic reforms have resulted in a dead-end for African development; and he instead called for new beginnings with state activism to address developmental and democratic objectives and overcome market failures.⁶⁴

The NBE, as a juridical entity, has always been the sole regulator of the financial service sector of Ethiopia. Especially after 1991, with the end of socialism and introduction of free-market economy in Ethiopia, the bank got more powers, inter alia, to license, supervise and regulate the operations of FIs.⁶⁵ It also acts both as a central and commercial bank for the GOE.⁶⁶

2.3.3 Ethiopian Financial Regulatory practice

Ethiopian Financial regulatory practice consists of the following entry, exit and operational requirements. Based on nationality, Ethiopia prohibits the ownership of FIs by foreign nationals. The number and size of FIs in Ethiopia is not limited. However, FIs are prohibited from directly engaging in other financial businesses even though they can hold shares up to 20% of capital in such businesses. For instance, such total holdings shall not exceed 10% of the bank's net worth or banks may not invest more than 10% of their net worth in other securities. The aggregate sum of all investments at any one time (excluding investment in government securities) may not exceed 50% of the bank's net worth; wherein the holding of the bank shall not exceed 10% of its equity capital.⁶⁷ Similarly, regarding the limitation on the acquisition of shares, Ethiopian financial laws clearly provide that no person, other

⁶² Honohan(2008) p.7

⁶³ Ibid

⁶⁴ Zenawi(2007) p.29

⁶⁵ NBE establishment (amendment) proclamation arts 2(12), 4, 5 and 14

⁶⁶ Id, art 5(14)

⁶⁷ NBE Directive No.SBB/12/1996

than the Federal Government of Ethiopia, may hold more than five percent of FIs' total shares either alone or jointly with relatives of first degree.

The initial capital requirement is USD 24.9 million for Banks, USD 2.9 million for Insurances and USD 99,750 for Microfinances. Moreover, for banks and insurances, 25% of the subscribed capital must be paid and deposited before the commencement of their business.⁶⁸ Besides, banks and insurances must, respectively, deposit 25% and 10% of their annual net profit with the NBE.

Regarding the location and opening of branches, FIs must apply for a permit from the NBE and must re-register when savings mobilized reach USD 49,875.3. Permit for operation and change of addresses is also mandatory. Regarding legal form, FIs must be established as share companies. Insurance-auxiliaries can be individuals whereas corporate brokers or surveyors shall be general-partnerships.

Regarding management structure and qualifications including office term, voting right, age, qualification and integrity requirements, Ethiopian laws prescribe the conditions for the board of directors and chief executives of FIs. The NBE issues and annually renews FIs' licenses with full discretion. Without written approval by the NBE, FIs must not close, change, dispose, restructure, or merge their business. The same is true to undergo bankruptcy, dissolution or liquidation.

Account opening in foreign currency is limited to establishments and bodies like international organizations, diplomatic groups, foreign investors, foreign nationalities working with such institutions, foreign citizens of Ethiopian origin and Ethiopians in Diaspora.⁶⁹

Ethiopian banks are eligible to open accounts with different banks abroad subject to reporting to the NBE for subsequent registrations. Payment in hard currency among residents of Ethiopia is prohibited. However, exporters are given priority to obtain external financing or use suppliers' credit. Furthermore, foreign investors can borrow from abroad having registered at the NBE.⁷⁰ The NBE is also mandated to observe the transparency of FIs. This in-

⁶⁸ Ethiopian Banking Business proclamation art 19(1) and Insurance business proclamation art 22(1)

⁶⁹ WTO MFTR(2007) p.23

⁷⁰ Id, p.24

cludes making on-site inspection and checking how FIs keep their records and accounts, evaluate their assets and report their activities.

Generally, while analyzing Ethiopian financial regulatory requirements in light of GATS, conditions like minimum capital requirements are compatible as long as they are applied objectively and reasonably. However, requirements like nationality-based discrimination are contradictory. Therefore Ethiopia might have to revise those laws and practices before joining the WTO or should get accession commitments that maintain those requirements. (See detail discussion under section 3.2 and 3.3).

2.4 Current Degree of Openness of the Ethiopian Financial Service Sector

Following decades of tight economic centralization, Ethiopia has been undertaking unilateral policy measures since 1992 through structural adjustment programs and poverty reduction strategic papers. Measures like privatization, substantial reduction of tariff and non-tariff barriers, reduction and gradual elimination of all controls on domestic prices, deregulation and realignment of foreign exchange rates and liberalization of investment policies are the results of the aforementioned reform programs. Some of these commitments were beyond what other LDCs as members of the WTO have accepted. However, these reforms were not multilaterally negotiated to give reciprocal concessions for Ethiopia.⁷¹

The financial service sector was part of the above reform programs and it had focused on privatization. However, the opening of the sector for foreigners was not achieved despite huge pressure from the United States.⁷² Ethiopian Investment proclamation identifies four major modes of investment in Ethiopia: a) areas exclusively reserved for the government; b) areas exclusively reserved for Domestic investors⁷³; c) areas permitted to foreign inves-

⁷¹ Delelegn(2005) p.201

⁷² Bezabeh(2014) p.33

⁷³ Ethiopian investment proclamation art 2(5) “domestic investor” means an Ethiopian national or a foreign national treated as a domestic investor as per the relevant law, and includes the government, public enterprises as well as cooperative societies established as per the relevant law.

tors⁷⁴; and d) areas that are owned jointly by public and private or by foreign and domestic investors.⁷⁵ Financial services are under Category b.

Similarly Ethiopian financial laws⁷⁶ provide that foreign nationals or organizations fully or partially owned by foreign nationals are not allowed to own FIs. Article 12(1) of the banking business proclamation and Article 11(1) of the insurance business proclamation also puts a cap on the acquisition of share saying no person, other than the Federal GOE, may hold more than 5% of the total shares, either alone or jointly with relatives of the first degree.

Furthermore, Investment Incentives and Investment Areas Reserved for Domestic Investors Council of Ministers Regulation No. 270/2012, under Article 3(1)(a), 3(2) and 4, provides that FIs are exclusively reserved for Ethiopian Nationals. Similarly Article 2(15) of the same legislation defines “Company” to mean a share company in which the whole shares are owned by Ethiopian nationals and registered under Ethiopian laws having its head office in Ethiopia.

Generally Ethiopian legal regime regarding FIs regulation puts nationality, form and investment limitations. Foreigners cannot own FIs in Ethiopia. The maximum amount of investment (shares) to be held by a single investor in each FI is also limited. Besides, there is a prohibition on investors with substantial investment in one FI (influential shareholders) from investing in any other FI. FIs should also be share companies. Moreover, there are minimum capital requirements under each FI.⁷⁷ In other words, Ethiopian law has delineated the scope of FIs activities and limited the scope of equity participation of FIs in other firms.⁷⁸ On the other hand, there is no limit on the number of FIs that have to be licensed or

⁷⁴ Ethiopian Investment Proclamation art 2(6) “foreign investor” means a foreigner or an enterprise wholly owned by foreign nationals, having invested foreign capital in Ethiopia or a foreigner or an Ethiopian incorporated enterprise owned by foreign nationals jointly investing with a domestic investor, and includes an Ethiopian permanently residing abroad and preferring treatment as a foreign investor.

⁷⁵ Ethiopian Investment Proclamation art 6-9

⁷⁶ Insurance Business Proclamation art 10, Banking business proclamation art 9, and Micro-Financing Business proclamation art 25

⁷⁷ WTO MFTR(2007) p.65

⁷⁸ Kassahun(2012) p.204

on the size they should have.⁷⁹ There is no limitation on the number of service suppliers and limitations on the total number of service operations or on the total quantity of service output. Likewise, there is no ceiling on capital entry.

Finally, the degree of Ethiopian Financial service sector's openness varies based on the mode of supply. It is closed from commercial presence of foreign FIs in Ethiopia (Mode 3). Cross-border supply of financial services (Mode 1) is permitted for selected services and institutions in insurance and banking sectors. Cross-border purchase of financial services is not explicitly regulated. There is no prohibition of consumption-abroad of financial services (Mode 2) as long as foreign exchange requirements are met. The same is true for Mode 2 export of financial services. Finally, with regard to the presence of natural persons in Ethiopia to supply financial services (Mode 4), the NBE allows certain kinds of service providers to deliver their service in Ethiopia.⁸⁰ (See section 2.3.1).

⁷⁹ Id, p.215

⁸⁰ Ageba(2008) p.9

3 The Impact of Ethiopian Accession on the Financial Service sector

In this chapter the key aspects of GATS for Ethiopian accession and the potential impact of Ethiopian accession on the financial service sector will be dealt with. In doing so, the four modes of financial service supply, the different scenarios under each mode and the potential impacts of the accession commitments on each scenarios will be discussed.

3.1 Modes of supplying financial services

International trade in financial services can occur in different modes and GATS Article I (2) distinguishes four of them. These modes are essentially defined on the basis of the origin of the service supplier and consumer, and the degree and type of territorial presence they have at the time of service delivery.⁸¹

First, consumers can buy financial services through "long-distance" purchase while physically remaining in their home country known as "cross-border supply" or Mode 1. Today, technological advancement mainly in information and telecommunication has greatly facilitated cross-border supply of financial services, with Internet-banking or online purchase of insurance policies being common distribution channels.⁸² The supply of a service through telecommunication or mail is an example of cross-border supply since the service supplier is not present within the territory of the member where the service is delivered or consumed. International money transfer using foreign banks is common in Ethiopia despite limited use of cross-border supply of financial services due to legal, technological and communication barriers.

Alternatively, consumers can travel to and buy financial services in the country where the financial services provider is located called "consumption abroad " or Mode 2. This mode of supply requires the movement of the consumer. The essential feature of this mode is that the service is delivered outside the territory of the member making the commitment. In this

⁸¹ GATT-MTN(1993) p.7

⁸² Chavan(2013) p.19

regard, because of trade, education, work, tourism etc., many Ethiopians travel abroad and hence the use of financial services under this mode is inevitable. The use of financial services delivered by Nordea Bank by Ethiopian students pursuing their studies in Norway can be a good example.

The third mode of supply is the establishment of subsidiaries or branches in the destination market known as "commercial presence" or Mode 3. This can also occur through the establishment of new FIs known as "greenfield investment" or purchase of or investment in existing FIs. In Ethiopia, the latter is done in the context of privatization programs (since 1992). This mode of supply in general covers the majority of global financial services supply in terms of sales (turnover), output, employment, value added, and number of enterprises involved.⁸³ Commercial presence covers not only the presence of juridical persons in the strict legal sense, but also legal entities, which share some of the same characteristics. Commercial presence thus includes, inter alia, corporations, joint ventures, partnerships, subsidiaries and branches.⁸⁴ In Ethiopia, as discussed under section 2.2, most of the financial service supply is conducted using this mode but only by domestic FIs.

Finally, trade in financial services can occur in the form of individual persons travelling to the destination country and selling financial services, which is known as "presence of natural persons" or Mode 4. This mode covers natural persons who themselves are service suppliers. In financial services, Mode 4 is mostly a consequence of commercial presence of FIs.⁸⁵ Service provided by loss assessors, loss adjustors, actuaries or international auditors are some examples in Ethiopia.

3.2 Key aspects of GATS for Ethiopian accession

GATS consist of the framework agreement, its annexes, schedules of specific commitments and list of exemptions from MFN treatment by members. Specific commitments are either horizontal or sector-specific undertakings to provide market access and national treatment

⁸³ World Trade Organization International Trade Statistics(2014) p.46

⁸⁴ GATS art 28(d)

⁸⁵ Dihel(2010) p.338

on the terms and conditions specified in the schedule. Accordingly, while analyzing the relations between GATS and Ethiopia the following issues are crucial.

3.2.1 Pro-LDC Objectives

One of the major objectives of GATS as underlined under its preamble is to increase LDCs participation in trade in services by considering their interests and asking flexible application of WTO rules.

The General Council's decision⁸⁶ on how to handle LDCs' accession provides that WTO members should exercise restraint in seeking concessions and commitments on trade in services. Moreover, acceding LDCs shall offer market access through reasonable concessions and commitments and that should commensurate with their individual development, financial and trade needs. Similarly Article IV (3) of the GATS expects special priority to be given to LDCs in the implementation of negotiated specific commitments while Article XIX requires progressive liberalization from LDCs on the negotiation of specific commitments by opening fewer sectors, liberalizing fewer types of transactions, and progressively extending market access. LDCs can also attach conditions while opening their markets. Nevertheless, WTO's practical experience has been questioned repeatedly as acceding LDCs took more commitments while making fewer limitations.⁸⁷ This trend is increasing through time and Ethiopian accession might be no exception.⁸⁸

3.2.2 Market Access

WTO members cannot take restrictive measures like quota, requirements of form and maximum foreign-shareholding other than what is listed in their schedule under the GATS. Any such measures that violate the market-access obligation must be clearly inscribed. That is, when states join the WTO they have agreed to give market access and once that commitment is registered in their schedule, they cannot retrieve and take restrictive actions.⁸⁹

⁸⁶ WTO Annex 4 Guidelines for Accession of LDCs(2003) and WTO Accession of LDCs(2012)

⁸⁷ Hawthorne(2013) p.68

⁸⁸ Ghebregergs(2013) p.24

⁸⁹ Hawthorne(2013) p.90

Article XVI of GATS provides that each member shall accord services and service suppliers of any other member treatment no less favorable than what is provided under the terms, limitations and conditions agreed and specified in its schedule. Such limitations even if they are not discriminatory are prohibited.⁹⁰

Ethiopia like many LDCs has set various types of limitations (see section 2.3.1 and 2.3.3) on market access on different modes of financial supply and in particular on access through commercial presence. These limitations revolve around ownership rules for foreign companies, the type of legal entity that a FI is allowed to operate, the amount of shares allowed for shareholders in FIs, the value of transactions or assets etc.⁹¹ Ethiopian accession negotiation will, therefore, focus on adjusting or recognizing these limitations.

3.2.3 National Treatment

Based on Article XVII of GATS, for all sectors inscribed in members' schedule and subject to any conditions and qualifications set out therein, each member shall accord to services and service suppliers of any other member, in respect of all measures affecting the supply of services, treatment no less favorable than what it accords to its own like services or service suppliers. This tries to avoid all formally identical or different discriminatory treatments and measures that may modify the conditions of competition to the detriment of foreign services or service suppliers.⁹²

In other words, under the service sub-sectors listed in a member's schedule of commitments, a member may not take discriminatory measures against foreign services and service suppliers. Foreign FIs and their services must be treated as favorably as domestic ones.⁹³ Any measures that violate the national treatment obligation must be clearly listed in members' schedule.

For LDCs who joined the WTO with infant domestic FIs, restrictions on national treatment are strong on mode 3. These restrictions revolve around registration, authorization, per-

⁹⁰ Kassahun(2012) p.204

⁹¹ Cattaneo(2010) p.13

⁹² GATS art 17(3)

⁹³ Herrmann(2014) p.518

formance, taxation, subsidization and technology-transfer requirements; licensing standards and qualifications; and nationality and residency requirements.⁹⁴ Ethiopia has, so far, denied market access to foreign FIs and hence measures affecting the supply of financial services are only applicable to domestic FIs.

3.2.4 MFN

Based on GATS (Article II) each member must accord immediately and unconditionally to services and service suppliers of any other member treatment no less favorable than what it accords to like services and service suppliers of any other country. This requires members to treat all WTO members at equal terms in trade in services. WTO members may not discriminate among foreign-service providers by offering more favorable treatment to service providers of one country. The best access conditions that a country has conceded to one state must automatically be extended to all other members.⁹⁵ Members are permitted to maintain existing measures that contravene MFN obligations by listing on their MFN exemption list.⁹⁶

In Ethiopia, there is no distinction among the services and service suppliers from various countries. However, there are exemptions for trade agreements for which Ethiopia is a member including IGAD and COMESA.⁹⁷ Looking at the financial service sector, foreign FIs are prohibited to operate in Ethiopia and hence it is impossible to analyze the applicability of MFN's principle. However, if Ethiopia joins the WTO, with the same rules in the service sector and by opening the financial sector, there will be no discrepancy.

3.2.5 Transparency

GATS Article III requires members to publish promptly all relevant measures of general application that may affect its operation except in the case of emergency. This obliges members to disclose any regulatory or institutional frameworks and changes that affect

⁹⁴ Cattaneo(2010) p.13

⁹⁵ UN MFN(2010) p.13

⁹⁶ GATS art 2(2)

⁹⁷ Zerihun(2014) p.7 and WTO MFTR(2007) p.65 i.e. For instance Ethiopia has reduced its maximum MFN tariff by 10 percent as a member of COMESA

trade in services as “foreign service” suppliers can face significant difficulties in operating in a country where domestic regulatory rules and regulations are vague.⁹⁸

In this regard, Ethiopia publishes its laws in its official journal, the *Negarit Gazeta*, sends sectoral regulations including financial market regulations to the regulated institutions and makes all laws and directives publicly available. It has also established a trade enquiry point from which information about laws and regulations can be accessed.⁹⁹ Regarding the publication of measures of a general application in Ethiopia, there is no specific legislation. NBE in particular, has no such obligation except to disclose the information it collected from the FIs in exceptional cases.¹⁰⁰

3.2.6 Domestic regulation

Another critical issue for discussion in the GATS is Article VI. In sectors where special commitments are undertaken, each member shall ensure that all measures of general application affecting trade in services are administered in a reasonable, objective and impartial manner. For instance, qualification requirements and procedures, technical standards and licensing requirements should not constitute barriers to trade; be based on objective and transparent criteria; and not be more burdensome than necessary to ensure the quality of the service. Shortly, GATS recognizes prudential carve-out for investor, consumer and public interest protection; financial system integrity and stability; and monetary and national development policy reasons. However, such regulatory measures shall not be designed and used to avoid member’s commitments.

3.2.7 Payment and transfers

Except in the case of restrictions to safeguard the balance of payment and external financial difficulties, members shall not restrict international transfers and payment for current transactions related to its specific commitments. The restrictions should be non-

⁹⁸ Cattaneo(2010) p.10

⁹⁹ Stern(2007) p.99

¹⁰⁰ NBE establishment (amendment) Proclamation art 22 i.e. Exceptional cases include providing information to the Prime Minister, orders of a court and other legally authorized recipients.

discriminatory, consistent with the IMF rules, and temporary.¹⁰¹ Such restrictions should also avoid unnecessary damage to the commercial, economic and financial interests of other members, should not exceed what is necessary to address the problem, and should not be used to protect specific industries or sectors.¹⁰²

Ethiopia, without liberalizing the capital account regime, allows international capital transfers and payments on current transactions, international remittance and repatriation of funds in respect of foreign investments.¹⁰³ Besides, the foreign exchange regime has been liberalized to allow domestic banks to retain and manage international foreign exchange positions in respect of imports and exports.

3.3 Reckoning potential liberalization commitments and their impact

3.3.1 Mode 1 Cross-border supply of financial services to Ethiopia

In mode 1 the number of alternatives to liberalize financial services trade are limited. These are the status quo; conditional liberalization and the removal of all restrictions of cross-border supply of financial services.

3.3.1.1 Scenario I Status quo

This scenario carries the possibility of rejecting the cross border supply of financial services in Ethiopia from a financial service supplier located abroad. As discussed under section 2.3.1, Ethiopian laws in principle do not allow cross boarder supply of financial services except in few cases. The realization of this scenario will then require changes in the existing legislations to allow cross-border financial service.

However, this scenario will face two main challenges. One, Ethiopian banking and insurance institutions need the help of foreign FIs under re-insurance to cover large and long term risks. For instance, this is true despite the recent introduction of re-insurance business by local insurance companies. Therefore, without developing the capacity and infrastructure of FIs locally it is difficult to deny the cross boarder supply of financial services.

¹⁰¹ GATS art 11 and 12

¹⁰² Kassahun(2012) p.227

¹⁰³ Ethiopian Investment Proclamation art 26

Two, today where digital information and technology connected the world, there is a demand for quality and efficient financial services through cross-border supply to which Ethiopian financial service sector is no exception.

To see the economic impacts of this scenario, exposure to foreign exchange risks and spillover effects of foreign capital market developments and technology transfer are vital considerations. Regarding the former, it should be noted that cross-border trade in financial services is a mode of supply that is most dependent on international capital transfers. Similarly for GATS accession offers and negotiations, cross-border movement of capital and foreign currency is an essential part of the service itself, that members are thereby committed to allow such movement of capital.¹⁰⁴ Liberalization of this mode is therefore difficult unless accompanied by commensurate liberalization of the capital account.

As both past and current financial crises have shown, cross-border supply of financial services exposes a country to a spillover effects from external crises. Ex ante, the likelihood of realizing costs or losses from cross-border trade are difficult to assess.¹⁰⁵ Under risk adverse considerations and keeping in mind that a healthy financial sector is a vital ingredient for the functioning of the economy at large, a cautious approach in opening this mode is advisable.¹⁰⁶ Smaller economies like Ethiopia are more vulnerable to capital movements that result in financial volatility and destabilization of domestic bank credit.¹⁰⁷ In particular, Ethiopia, with major drawback in the supply side of services, a huge gap between imports and exports and chronic shortage of foreign currency, cannot afford to undertake capital account liberalization. Therefore, maintaining capital controls (staying unbound) is the best option for Ethiopia.¹⁰⁸

Technology transfer from cross-border supply of financial services is very limited. This is because as the service provider remains in its home country and both consumers and domestic FIs are unable to gain access to improved skill, technology and working mecha-

¹⁰⁴ GATS footnote no.8

¹⁰⁵ Ernst(2011) p.223

¹⁰⁶ Wolla(2013) p.3

¹⁰⁷ Stebek(2007) p.90

¹⁰⁸ Kassahun(2012) p.231

nisms. Cross-border trade in financial services thus has very limited positive spillover effects for the development of Ethiopian financial service sector and economy.¹⁰⁹

Countries with stable financial systems and sound macroeconomic and regulatory framework have every reason to apply broad liberalization strategy and commit to far-reaching commitments in this mode. However, in countries with weak financial systems, potentially volatile capital flows can be highly destabilizing, resulting in banking and currency crises.¹¹⁰ For instance, foreign banks might serve as conduits for inward and outward financial flow and might take “cut and run” policy whenever they felt a financial crisis is about to emerge.¹¹¹ They might also shift funds abruptly from one market to another if they perceive changes in risk-adjusted returns. This will lead into full-blown economic crises and political instability.¹¹² Therefore, at least until the necessary domestic regulatory capacity and sound economic settings are created, it seems preferable for Ethiopia to keep this mode closed.¹¹³

In sum, the liberalization of cross-border trade in financial services carries more risks and fewer benefits. Given the limited importance of cross-border trade in financial services in Ethiopia today, the impact of these risks may be small in quantitative terms.¹¹⁴ This mode, which is highly dependent on international capital transfers, is the most sensitive mode and from the experiences of recently acceded states, it is possible for Ethiopia to maintain the status quo.¹¹⁵

3.3.1.2 Scenario II Conditional liberalization

Conditional liberalization of mode 1 is the opening of cross-border supply of financial services with limitations like phasing out of barriers over a transition period; or restricting the type of sectors, the amount of capital or the group of persons or institutions allowed to engage in this mode; or allowing the use of cross-border supply of financial services only

¹⁰⁹ Ageba(2008) p.13

¹¹⁰ IMF(2012) p.4

¹¹¹ Claessens(2012) p.4

¹¹² Id, p.17

¹¹³ Kassahun(2012) p.225

¹¹⁴ Stern(2007) p.xx

¹¹⁵ Kassahun(2012) p.215

in explicitly listed exceptional cases. This scenario is practically advantageous as it enables Ethiopia to continue filling the gap of domestic FIs service supply capacity while minimizing associated risks with cross-border supply. Shortly, this scenario balances the negative and positive sides of liberalization in this mode while giving regulatory space for Ethiopia. It will be useful even if foreign FIs are introduced in other modes. On the other hand, this scenario requires amendments on the current regulatory laws of Ethiopia so as to explicitly mention the cases where cross-border supply of financial services will be allowed. On the other hand, the cases where mode 1 will be open can be mentioned in Ethiopian schedule of commitments.

3.3.1.3 Scenario III – Cross border trade in financial services will be fully liberalized

The other option for Ethiopia in mode 1 is to fully open the cross border supply of financial services. It is beyond the status quo and partial liberalization of the sector as not only Ethiopian FIs, public enterprises and sub-sectors form abroad but also consumers will have direct access to financial services from abroad. This scenario will require deeper changes in the financial regulatory laws of Ethiopia in order to remove existing prohibitions.

Cross-border trade in financial services entails opportunities to engage in advanced, modern and efficient financial activities from the international market which will allow a higher margin than the Ethiopian market despite only for a very few portion of consumers who are able and aware of consuming financial services under this scenario. Besides, the opening up of this mode will increase the type of financial products and the capital base of the sector.

However, with limited digital and technological capacity, infant domestic FIs and poor regulatory capacity of the NBE, the possibility of facing one-way traffic of financial services supply under this scenario is high. This is because of Ethiopian domestic inability to make cross-border supply of financial services to the financial service customers located abroad and due to pre-existing cross border financial service supply capacity and experience from foreign financial service suppliers to customers located in Ethiopia, the market access advantage that may be achieved with this scenario is negligible. Besides, Ethiopian FIs, with poor telecom and technological infrastructure, has little to offer while there will be a huge supply of financial services from foreign FIs following such liberalizations.

Hence, from a market access point of view, this scenario offers very little for Ethiopian FIs unless it is used as a leverage to hold-on commitments in other modes.

On the other hand the permission of mode 1 in the financial service sector will not contribute much in improving competition, reducing the concentration of FIs in urban areas or improving the accessibility of FIs in rural areas, and multiplying financial products. This is because the potential consumers of financial products in this scenario are very few located in urban areas for infrastructural and technological reasons. Rather, liberalization in this regard, will force domestic FIs to stick to rural areas, poor consumers and traditional financial services, as large-scale, urban and elite consumers will be covered by cross-border supply from foreign FIs. However, Ethiopian major problem in the financial service sector i.e. inaccessibility of financial services will remain unsolved.

The issue of confidence between the supplier and consumer in this scenario will be another reason to make this scenario practically difficult. For instance to seek loan or to purchase insurance policy from a FI located abroad, the necessary check up procedures, guaranty mechanisms and institutional structures will be far and limited in Ethiopia. However, by their very nature financial services require high level of trust between the supply and demand sides.¹¹⁶ Therefore, lack of confidence of FIs on Ethiopian consumers and vice versa will be an obstacle from getting the limited benefits of this scenario.

To conclude, it is understandable for the GOE to seek to maintain the status quo due to big risks involved in cross-border supply of financial services. However, considering its FIs' gap and dependency on foreign FIs, conditional liberalization that balances the prospects and risks of this mode is the best option for Ethiopia. Similarly, for WTO members, where there are few potential consumers, infrastructural and technological barriers in Ethiopia, and questions of trust and confidence between their FIs and Ethiopian consumers, mode 1 is not the most ideal one either. Therefore, conditional liberalization seems feasible for both WTO members and Ethiopia.

¹¹⁶ Staschen(2013) p.26

3.3.2 Mode 2 Consumption of financial services by Ethiopians abroad

Consumption abroad of financial services i.e. Ethiopians opening bank account or purchasing insurance policy while being abroad is very difficult to regulate. The whole transaction takes places outside of Ethiopia following the cross boarder movement of the consumer unlike the cross border supply of the financial services themselves. However, it involves transnational capital flows with the consumer and that requires indirect monitoring.¹¹⁷

The importance of mode 2 trade in financial services, and hence its potential impact on the Ethiopian financial services sector or on the economy in general, is limited.¹¹⁸ The only thing that may be at stake as far as Ethiopian FIs and regulators are concerned in this mode is the fulfillment of monetary and foreign exchange requirements while going abroad or returning to Ethiopia. That is; as far as Ethiopian consumers fulfill the necessary conditions, like declaring foreign currency, the Ethiopian financial service sector will not face any difficulty. However, given the high level of corruption (see section 3.4.2), opening this mode should be considered with the goal of reducing the flow of public money out of the country without proper regulation.

Moreover, the opening up of this mode will only require few legislative changes as Ethiopia currently does not prohibit Ethiopians from going abroad and consuming financial services other than obliging the disclosure of foreign currency at the time of entry and exit (see section 2.3.1).

However, liberalization in this mode together with the result of liberalization in other modes might motivate Ethiopian domestic FIs to increase their capacity and efficiency in the long run to reach Ethiopian consumers located abroad without additional burden. This can be seen from two angles. One, if Ethiopia is to commit full liberalization in mode 2, there will be no additional duty or negative consequence beyond the current reality. Two, following such liberalization, foreign FIs will be officially recognized and continue to serve Ethiopian consumers located outside of Ethiopia (in their territory or beyond). This, howe-

¹¹⁷ Arkell(2010) pp.142-143

¹¹⁸ Ageba(2008) p.13

ver, is a matter of fact regardless of the opening up of this mode and it is not up to Ethiopia to do otherwise.

Ethiopia, therefore, is less likely to bear pressure to commit in this mode. Considering the difficulty of regulating the consumption of financial services abroad, this mode also seems easy for GOE to accept.¹¹⁹ The experience of recently acceded countries with the exception of Nepal also shows that this mode has been fully liberalized in all cases. Therefore, offering full liberalization of this mode, which bears no cost, is a harmless decision for Ethiopia.¹²⁰

3.3.3 Mode 3 Commercial presence of foreign FIs in Ethiopia

For the physical entry of foreign financial service providers into the Ethiopian market, different scenarios can be identified. This varies from the preservation of the existing regime to allowing full foreign ownership of FIs in Ethiopia. In between, foreign partial or joint ownership of FIs through equity participation, “greenfield investment”, branches and subsidiaries are other possibilities.¹²¹ The first two scenarios represent the highest possible demand by the GOE to retain the sector closed for foreign FIs and the demand of WTO members for full liberalization of the sector. The rest scenarios represent partial joint venture ownership of existing FIs, establishing new FIs or both by foreigners.¹²²

From experience most DCs have allowed this mode of supply with different restrictions on the extent of foreign participation. Besides, national treatment limitations in this mode are wider compared to limitations on market access.¹²³ Currently, Ethiopia has one of the few overtly protected financial markets in the world prohibiting the commercial presence of foreigners in the financial sector (see section 2.3.1). Thus, this will be the most important subject of negotiations in Ethiopian accession bid and possibly the entire accession negotiations can become contingent upon its outcome.¹²⁴

¹¹⁹ Kassahun(2012) p.216

¹²⁰ Ibid

¹²¹ Ageba(2008) p.14

¹²² Stern(2007) p.127

¹²³ Kassahun(2012) p.217

¹²⁴ Id, p.216

3.3.3.1 Scenario I – Maintaining the status quo

This section deals with a scenario in which the commercial presence of foreign financial service providers is totally prohibited. As has been discussed earlier in section 2.3.1, market access under the current regime excludes the presence of foreign FIs in Ethiopia and forces consumers to use domestic FIs and the GOE might try to retain this position. However, reserving financial services to Ethiopian nationals, which will not require legal and regulatory changes, is likely to face strong challenge and rejection from WTO members. Thus, potentially, there exists a very small chance that Ethiopia will be able to join the WTO without being committed to anything in this particular mode.

The main beneficiaries of the status quo are domestic infant FIs, whereas the overall effect on the economy is likely to be less positive, with the exception of availability of rural banking and micro-finance services.¹²⁵ However, even from domestic infant FIs point of view, public and private FIs (particularly banks) will have different reaction with a varying degree. This is because (as indicated earlier in section 2.2.1) private banks are under unnecessary and tight regulation of the NBE whereas public banks remain dominant and beneficiaries of such hindrance of private banks. Consequently, facing the tough but free competition from strong and experienced FIs from abroad is a lesser evil for domestic private FIs who are yet to wine the dominance of public FIs. They can use their experience and nexus with domestic consumers to wine such competition once the restrictive environment is adjusted. In the past two decades, even with the difficult working environment, Ethiopian private FIs stayed profitable and successful. However, much would have been achieved, had it not been for the inefficient financial regulation and weak business environment in the system.

In other words, what the status quo holds for domestic FIs is a restrictive regime, considerable concentration and competition between ‘unequals’ as far as they and state-owned FIs are concerned. This is because public FIs are relatively well established, with large network of branches, high capital and reserve base. These facts contribute towards reducing

¹²⁵ Ageba(2008) pp.14-15

costs of public FIs and enhance their capacity. In addition, there exists no competition among the state owned FIs who are working in a cooperative manner.¹²⁶

Moreover, maintaining the status quo will have different impact on stakeholders in each financial sub-sector. It is good news for domestic public FIs as they can continue their dominance and the NBE as there will be no additional task of regulation. If the dominant position of the CBE is unchallenged, the current cross-subsidizing mechanism for rural branches to ensure rural finance in the banking business can continue.¹²⁷ The same will be true for Ethiopian MFIs and their consumers. However, private domestic FIs as discussed above will have mixed feelings; the continuation of restrictive regulatory system and uncompetitive financial environment is a bad news while the protection against the competition from strong and experienced foreign FIs with huge capital and reputation is a good news allowing them to develop at their own pace.

From Ethiopian consumers' point of view, the following can be said. After liberalizing the sector for private domestic FIs since 1992, competition is still limited and the market continues to be dominated by public FIs with poor quality and limited efficiency. The increase in the number of FIs or branches has not led to increased competition and there is indeed little prospect that the establishment of further domestic private FIs would significantly change this situation without the introduction of international state-of-the-art and technology, and without changing the way how the sector is regulated.¹²⁸

Particularly in the banking sector, access to finance heavily depends on the availability of collateral restricting the availability of loan finance in the Ethiopian economy. There is also a financing gap for long-term credits, retail lending and housing & construction loans. The poor coverage of banking services, especially in rural areas and the portfolio of banking products in Ethiopia has remained limited and without the transfer of international capital and know-how, it would remain the same.

¹²⁶ Lelissa(2007) p.58

¹²⁷ Stern(2007) p.126

¹²⁸ Ibid

Similarly in the insurance sector, domestic insurance companies will be shielded from foreign competition and can continue to develop at their own pace. However, there is no developmental benefit that is comparable to the CBE's role in securing rural finance and the national payment system. Besides, private insurance companies hold more capital and customers than the public insurance companies. Therefore, maintaining the status quo will have no larger public interest arguments in the insurance sector.

Moreover, despite the existence of high competition in the insurance market the product range has remained limited, and large and long-term risks coverage is rare. Insurance policies for life, engineering and agricultural risks are particularly lacking. Without an international impetus and know how this situation is unlikely to change. Outdated risk assessment and premium setting methods, and vague pricing methods will remain unimproved.¹²⁹

In Ethiopia, with large rural population, there is no shortage of viable business opportunities like in agriculture and small businesses. However, much of the financial system's asset is invested in government securities, and not enough is lent to privately held companies to grow their businesses and create jobs. This is due to NBE's requirement and the fact that lending to the private sector, especially small and medium-sized businesses, is risky, costly, and requires collateral that borrowers do not have.¹³⁰ Therefore, these problems will continue with the status quo.

Another way to analyze the entry of foreign FIs in Ethiopia compared to the status quo is the experience of the last twenty years. Ethiopian financial performance has improved since the introduction of private FIs regardless of the huge capital and opportunity possessed by public FIs, and this shows the strength of private FIs. For public banks interest-rate spread is smaller, cost is higher and the return of asset is lower than private banks.¹³¹ This shows the fast growth rate of private banks which results in better service quality and quantity. Therefore, by the same analogy, if foreign FIs are allowed to enter Ethiopian financial

¹²⁹ Bezabeh(2014) p.35

¹³⁰ Id, p.26

¹³¹ kapur(2012) pp.5-6

market at least without excluding the public dominant FIs for their public interest objectives, the competition and perceived advantages will be better.¹³²

Generally, maintaining status quo will bring nothing different for the Ethiopian financial sector than the poor reality available today and all the prevailing problems will continue. Besides, this scenario is hardly achievable. Even the GOE admits the existence of many problems in the current financial topography and it should, therefore, make elegant liberalization of mode 3 (anything other than the status quo) as part of a long-term solution.

Alternatively, the GOE might seek gradual and progressive liberalization with particular duration for maintaining the status quo upon which it will build domestic financial service capacity. Such opening requires a number of measures from the government and financial sector stakeholders including strengthening domestic FIs for increased competition on two levels. At the systemic level, the financial sector infrastructure needs to be improved like the telecom, electricity and information communication. This must go hand in hand with the second level where it builds the capacity of individual domestic financial services providers. Perhaps, even more important is the upgrading of the regulatory framework and supervision capacities.¹³³

3.3.3.2 Scenario II – Allow foreign partial ownership of FIs as equity participation in existing FIs

Foreign financial service providers entry through partial equity participation will offer flexible alternatives and require a significant amendment of existing laws that govern FIs in Ethiopia.

This scenario will increase the capital, skill and technology base of domestic FIs without competing them out of business. An increased capital base will increase the availability of loan finance to the economy in general while the skill and technology transfer will advance the quality and efficiency of the financial service system of the state.¹³⁴ Coupled with better credit allocation mechanisms and procedures, the aforementioned qualities will contribute

¹³² Stern(2007) p.132

¹³³ Ageba(2008) P.19

¹³⁴ Kassahun(2012) p.217

to enhance Ethiopian economic growth. With their better methodologies to assess risk and creditworthiness of customers, the entry of foreign FIs will improve competition, the mix of financial services, innovation, productivity, and risk management tools, thereby contributing to the overall soundness of the financial system.¹³⁵ The benefits would be even greater if foreign banks enter retail banking and lease financing in addition to corporate banking as that would fill a large financing gap in the country without having a major impact on domestic banks that are not currently operating in this market segment.

However, this scenarios' implications for agricultural credit and the availability of banking services in rural areas will depend on how the market shares will be affected in the most profitable market segments. These are in particular, the institutions that are providing rural banking services. Currently, MFIs, the CBE and DBE are the main formal sources of finance in rural areas eventhough their services remain limited. The CBE in particular holds the largest banking capital and maintains a large network of branches nationwide, making it the key institution in the payments system of the country. It is able to do so primarily by subsidizing its non-profitable branches out of its profits on its operations in major urban areas. Therefore, contribution in this regard depend on how small-scale consumers and profit margins are attractive enough for the enterant FIs or if those FIs are open for equity participation. Basically, foreign FIs will not focus on poverty alleviation issues and access of low-income and rural-based consumers other than profit making objective.¹³⁶

So far with the expansion of domestic private banks, the CBE is losing market and profit share in urban areas, where banks currently make most of their business. Consequently, following liberalization in this mode, the competition will be between the private banks with foreign equity participation and the CBE (assuming it remains fully state-owned). Thus, such a loss of market share and subsequent erosion of its capacity to subsidize will result in the reduction of its accessibility for rural consumers and declining ability to maintain its nationwide banking services.¹³⁷

¹³⁵ Cattaneo(2010) p.12

¹³⁶ Stern(2007) p.ix

¹³⁷ Id, p.128

Another possibility under this scenario is where the CBE allows the participation of foreign banks in its equity. This will strengthen its capital and efficiency without losing its dominant position and its objective of reaching for rural customers. It will not be weakened by increased competition from new foreign entrants while foreign banks are likely to see its extensive branch network as an asset.¹³⁸

Another option to preserve rural banking services while liberalizing this mode would be to establish specialized rural FIs like cooperatives and community banking or charge the DBE or MFIs with more responsibility and capital that would takeover rural lending activities from the CBE (similar to the experience of Indonesia and Kenya).¹³⁹ Consequently, CBE can be liberalized or relieved from making rural lending depend on its cross-subsidization from urban operations. Such schemes can be inserted as reservation under Ethiopian accession commitments.

The impact of this scenario on domestic savings mobilization depends on the degree to which foreign FI with equity participation rely on foreign funds (from their parent companies or borrowed abroad) to finance their lending operations and that will have an implication on the short-term capital flow component of Ethiopian capital account.¹⁴⁰ This is because external private finance is an unreliable source for domestic capital formation and access to foreign loanable funds exposes a country to foreign cycles due to shocks arising from external economic and financial developments affecting the domestic lending and deposit base.¹⁴¹

Nevertheless, foreign banks are unlikely to use foreign funds to finance domestic lending in Ethiopia because of the risks involved with foreign exchange. Likewise, the outflow of local savings out of the country is minimal. This will force banks with foreign equity to engage in domestic savings and collection of deposits by opening branches to finance their activities. Similarly, consumers will have more confidence in banks with foreign equity as they are expected to be well established at least better than domestic banks without foreign-

¹³⁸ Bezabeh(2014) p.34

¹³⁹ Staschen(2013) P.72

¹⁴⁰ Claessens(2013) p.15

¹⁴¹ Dobson(2008) p.297

equity participation. The only line of business that foreign banks would likely finance in foreign currencies is trade and that goes in line with the existing rules regarding the prohibition of private sector borrowing from abroad and with the most feasible negotiation possibility of denying the capital account liberalization.¹⁴² Besides, changes in the foreign exchange regime are not required so that the risks associated with this scenario are minimized. However, additional measures may be needed to ensure new entrants, who rely less heavily on domestic deposits, have a positive effect on domestic savings mobilization.

The main issue with regard to foreign equity participation is the maximum limit of such participation. That is, either to allow foreign majority share other than 100%- which will allow control of the company- or if it should be limited below majority. Another option is in line with the current financial regulation where the ownership by a single shareholder of FIs is limited to a maximum of 5% of shares (see section 2.3.3 and 2.4).¹⁴³ There is an obvious inverse relationship between the interest of foreign FIs to buy equity in domestic FIs and the ceiling on their participation.¹⁴⁴

Allowing foreign majority share will be attractive for foreign FIs but less likely to be accepted by the GOE because it will not be different from fully liberalizing and allowing complete control of domestic FIs by foreigners. If that happens, the above mentioned positive consequences (more competition and financial products, transfer of technology and know-how etc.) are likely to materialize while foreign FIs especially banks will be able to control the market and set prices after a while. That is because the chance of facing strong competition and resulting exclusion of domestic FIs from Ethiopian market is high.

Foreign ownership limit below majority share is mutually beneficial and acceptable for both the GOE and WTO members. However, allowing foreign equity participation more than 5% means the current limitation on the ownership by a single shareholders has to be revised. On the other hand, allowing foreign ownership in line with the current Ethiopian legislations will not attract foreign FIs.

¹⁴² Stern(2007) p.128

¹⁴³ Ageba(2008) p.14

¹⁴⁴ Stern(2007) p.128

The other option is one that combines the above scenarios to allow foreign FIs' entry through progressive amount of equity participation. In the above scenarios, domestic FIs would benefit to a certain extent from a substantial degree of protection and might prefer to remain infant and rent seeking, and lobby for the continuation of the ceilings on foreign equity participation. However, progressive increase of equity-participation can be a solution to that. Besides, domestic FIs especially banks may be sheltered behind foreign FIs' equity rather than taking advantage of their opportunity and winning the competition by building their capacity. Therefore, making restrictions on this form of progressive entry and time-bound is a wise strategy that can serve as a transitional and motivational factor for domestic FIs.

3.3.3.3 Scenario III - Establishment of new FIs with partial foreign ownership

Under the entry of foreigners in to Ethiopian financial sector through “greenfield” investments, both domestic state-owned and private FIs would face competition from newly established FIs that are not affiliated with foreign FIs. This scenario, which will require changes in the Ethiopian financial legislations from prohibiting foreign FIs to allowing their participation in such a way, will increase the number of FIs in the country and raise the capital base and competition level.

Given their current state in terms of capital, human resource, technology etc., existing domestic FIs would be exposed to stronger competition without benefiting from the transfer of know-how and technology in this scenario. This implies little advantage and huge risk of failure from infant industry argument point of view.¹⁴⁵ Consequently, resistance from the incumbent domestic FIs who will not be part of the new joint venture will be expected. However, consumers of the new “greenfield” investment FIs will be beneficiaries as they will have more options, better quality and cheap price of financial services.

This scenario will increase the number of FIs and this implies more competition. In Ethiopia, the number of FIs is still relatively small with very low FIs-to-population ratio (see table 1). However, the limited competition in the financial sector is not mainly a result

¹⁴⁵ Ageba(2008) p.15

of shortage in the number of FIs but the existence of dominant players, lack of capacity to compete and lack of financial products.¹⁴⁶ Consequently, the entry of new joint venture FIs and the increase in the number of FIs will not necessarily contribute to more competition. Equity participation in existing banks might be more desirable as it increases their capacity to compete with the dominant players than under this scenario.

In this scenario, as FIs are not formed jointly with existing foreign FIs, it will not bring FIs with huge reputation, capital and experience from abroad. Thus, competition with the existing domestic FIs and technology transfer is limited compared to other scenarios. Therefore, the chance of building and improving domestic infant FIs is minimal and hence, if Ethiopia is to liberalize commercial presence of foreign FIs, this will not be the best option. Looking at the relationship between this and the previous scenario, the initiative, freedom of foreigners and the impact on domestic FIs are the main differences. Both scenarios are joint ventures that need the participation of Ethiopians and foreigners. However “greenfield” investment allows foreigners to set up a new FI independently while the previous scenario allows them only to participate in already existing FIs. Accordingly, under the previous scenario domestic FIs have a say about the entry of foreign FIs by analyzing their performance and growth, and can decide if unity with foreign FIs or staying independent is beneficial for them. They can maximize their advantages and use the liberalization realities as an opportunity. This, however, is not the case under “greenfield” investment. Nevertheless, it is possible for foreigners to initiate Ethiopians to set up new FIs with whom they can form a joint venture. Therefore, to close such loopholes, allowing both scenarios simultaneously or limiting joint-venture foreign equity participation only with domestic FIs that exist before a certain period of time can be a solution.

3.3.3.4 Scenario IV - Establishment of fully foreign owned branches of FIs

Under this scenario, foreign FIs will be allowed to open branches with full ownership and without the need to independently incorporate in Ethiopia. This scenario is quite different from the status quo and will require the amendment of the existing regulatory laws.

¹⁴⁶ Ageba(2008) p.7

Generally, the relation between branches and parent companies regarding consumers' legal claim is complicated. On one hand, consumers of branch-offices can claim on the assets of FIs as a whole. Conversely, creditors of the parent FI can have claims on any of its branch. The same is true during insolvency. Therefore, the parent institution and its branch office cannot be separated and that may be both a security and risk.¹⁴⁷

Under this scenario, Ethiopian FIs can benefit from improved supervision and consumer protection experience of the entrant foreign FIs whose target is to stay profitable and maintain their reputation.¹⁴⁸ In other words, by serving clients active in more than one country, the new entrant FIs can achieve benefits from spreading best-practice policies and procedures. They are able to assess and diversify risk better and have more diversified funding sources.¹⁴⁹ Moreover, the entry of foreign FIs in emerging markets allows the introduction of stronger and more prudent regulation by the host-state, and this increases the soundness of the local financial service sector.¹⁵⁰ Similarly, this scenario will increase the competition deliver more financial products and broaden the capital base. Besides, from experience, branches of foreign FIs outperform domestic FIs and that is an advantage for consumers.¹⁵¹ However, branches of foreign FIs will have cream skimming behavior, with limited number of branches, focusing on the most profitable financial activities and consumers in Ethiopia where private returns than social; lending than borrowing; or large scale operators than small-scale consumers will be preferred.¹⁵² For instance, in the banking sector, following such cherry-pick character, domestic borrowing or saving, rural and retail banking, long term and development related financial services might be ignored. Of course like “greenfield investments”, branches of foreign banks may be forced to open more branches and collect domestic saving to finance their activities. This is because doing it otherwise will have foreign exchange costs. It will also contradict with the capital account regulation of the state unless changes are made during the accession negotiations (see section 3.3.1).

¹⁴⁷ Ageba (2008) p.17

¹⁴⁸ Dobson(2008) p.296

¹⁴⁹ Bezabeh(2014) p.33

¹⁵⁰ Claessens(2012) p.3

¹⁵¹ Id, p.1

¹⁵² Bezabeh(2014) p.34

The presumed efficiency of branches of foreign FIs, their range of products, ability to respond to customer needs, and the convenience of their global reach makes them attractive to exporters and importers in the new picture of competition while domestic FIs will remain with limited capacity and role. Besides, technology and skill share benefits for domestic infant FIs is minimal in this scenario. Foreign FIs' branches may therefore be in a good position to capture a significant part of the vital international trade finance and they will encourage the advancement of oligopolistic market structure.¹⁵³ This in turn will force domestic FIs to adjust their operations to win the competition and in the worst case to consolidate their operations through mergers or sell out. If this happens to public FIs, prioritizing developmental needs of the state, serving neglected sections of the society and spreading the accessibility of financial services across the country will retard. Similarly, if private FIs are forced to sell-out, the competition will be limited between branches of foreign FIs and domestic public FIs to the disadvantage of consumers.

On the other hand, even if it is tough for domestic FIs' growth, competition under this scenario will result in high quality service and cheap products for consumers at least in the short run. Comparing the reputation, experience and capital of branches of foreign FIs with the proximity of domestic FIs towards domestic consumers interest and existing regulations, the market will ultimately be decided by the best pricing and service quality. Moreover, the lack of financial infrastructure like electricity, Internet and information availability in Ethiopia will restrain branches of foreign FIs while domestic FIs are familiar with such realities. The end product of such strong competition is beneficial for consumers as both camps will be forced to exploit their opportunities to the maximum.¹⁵⁴ Lower borrowing costs and smaller interest-rate margins are good examples.¹⁵⁵

Regarding the regulation of FIs, this scenario will bring an extra dimension of branch-parent institutional relationship into the picture. Ethiopian regulators whose aim is to protect consumers will be concerned especially given the recent tendency of parent FIs to pre-

¹⁵³ Stern(2007) p.6

¹⁵⁴ EY(2014) p.14

¹⁵⁵ Claessens(2012) p.3

vent themselves against liabilities emanating from their foreign branches by including the so-called “ring-fencing” provisions.¹⁵⁶ However, it is possible to prohibit such kind of behavior by mentioning through Ethiopian market access commitments. As far as foreign FIs’ branches comply with the establishment, operation and closure rules of the host country, the chance of legal claims that goes beyond the asset of the branch offices is minimal. Simply, branches will be required to comply with domestic financial regulations as if they are incorporated under Ethiopian laws. One way of minimizing the risks of this scenario while maximizing the possible advantages is by allowing the opening of branches of foreign FIs in Ethiopia limited to reputable international FIs using international standards. For instance, allowing only international banks that comply with Basel standards or those that are rated high by international rating institutions (as in the case of Nepal) is one option. Another way of controlling the operation of branches of foreign FIs in line with the regulatory and economic demands of the host-state is by attaching conditions to their operation. This can include the requirement to engage in local currency denominated business, limitation on foreign currency transactions, requirement to engage in some untouched financial activities and regions of the host state. However, this will have three drawbacks. One, WTO members are unlikely to accept such arrangements. Two, it will reduce the interest of foreign FIs from penetrating the Ethiopian market. Third, it will harm the market by limiting the competition in attractive financial segments and consumers will not get the expected benefits.

3.3.3.5 Scenario V - Establishment of subsidiaries of foreign FIs

This scenario will introduce subsidiaries as separate entities from their parent FIs where creditors have no legal claims on the parent FI or any of its other subsidiaries.¹⁵⁷ Therefore, the relationship between consumers and subsidiaries of foreign FIs in Ethiopia will be limited locally based on their asset and financial performance. The regulation will also be total-

¹⁵⁶ Schwarcz(2013) p.78 i.e. provisions which establish that parent banks are not required to repay obligations of foreign branches facing repayment problems in connection with war and related cases.

¹⁵⁷ IMF(2011) p.7

ly based on Ethiopian laws which will require changes from the current closed reality.¹⁵⁸ The effect of this scenario is similar to scenario IV. Reputation plays a big role in this scenario despite the doubt to what extent big foreign FIs' operation in Ethiopia through subsidiary will affect their name and image.¹⁵⁹ As the operation of subsidiaries is independent and as the link between the parent institution from abroad and the subsidiary established in Ethiopia is far, this scenario is similar to that of "greenfield investment".

Welcoming subsidiaries has limited technology and skill transfer benefits as new entrant FIs' operational link with their parent institution is limited. Besides credit allocation might be skewed from the point of view of the government. Other benefits of liberalization like broadening the capital base, advancing the quality and quantity of financial products will be subjected to the kind of subsidiaries that will arrive in Ethiopia. Therefore to maximize such advantages, like in the case of branches, Ethiopia can attach conditions up on which subsidiaries will be allowed to enter the Ethiopian market. However, this scenario will improve the competition and financial activities in the country at least to a certain extent better than the current reality and that will support the productivity of the sector and its impact on the economy. In other words, improved competition in this scenario will force FIs to search for new customers and financial products to the best interest of consumers.

Regarding the impacts of this scenario on the regulatory practice and laws of Ethiopia, first, by bringing new players in the game, like the previous scenario, it will require changes in the existing regulatory laws. Second, the aforementioned facts add regulatory headaches for regulators especially given the limited capacity of the NBE. Therefore, compared to other scenarios, the liberalization of this scenario should not be Ethiopia's top priority as it has little significance for the country.

3.3.3.6 Scenario VI - Establishment of new fully owned foreign FIs in Ethiopia

This alternative allows the creation of new FIs or "greenfield investment" in Ethiopia (discussed under section 3.3.3.3) but with a full foreign ownership. Looking at its potential

¹⁵⁸ Schwarcz(2013) pp.8-9

¹⁵⁹ IMF(2011) p.9

impact, it is similar to scenario IV and V except that the new FIs in this scenario are independent from foreign FI.

This scenario will shake the current financial regulatory rules concerning the total prohibition of foreign ownership of FIs in the country. Generally, this scenario is equally beneficial and risky that it should not be prioritized at least in the short run. It will be highly attractive for foreign investors where as domestic FIs will face strong competition without the possibility for technology transfer. Besides, with high macroeconomic volatility this scenario will demand advanced regulation, which is not currently available in the country.

The current state of development of the financial sector in Ethiopia, where a large part of the population does not have access to FIs, is a positive factor that will attract foreign FIs in this scenario. It is, therefore, easier for foreign FIs to gain market share and therefore likely easier to be productive and make a higher profit. On the other hand, size is an important factor for the performance of FIs and if the new entrants under this scenario are big FIs, then domestic FIs are likely to lose the competition.¹⁶⁰

Increasing the capital base of the financial sector, catalyzing the competition and adding financial service quality and the portfolio of products are possible gains of this scenario for consumers. However, despite the high demand from WTO members for the liberalization of this scenario, the GOE will hardly accept such demands. This is because, considering the aforementioned risks, the state seems to be not ready for drastic changes in the financial system as the gap between the status quo and this scenario is huge.

3.3.4 Mode 4 Presence of natural persons in Ethiopia to provide financial services

In financial services, the presence of natural persons is usually a consequence of Mode 3 issues with the exception of some independent auxiliary services like actuaries or financial sector consultants.¹⁶¹ The use of this mode and its impact on the Ethiopian economy is considered to be minimal. There will also be less pressure from the accession negotiations and

¹⁶⁰ Bezabeh(2014) p.33

¹⁶¹ Dihel(2010) p.338

perhaps less concern from domestic economic considerations towards committing to this mode.

Almost none of the recently acceded countries made commitments in this mode and thus, Ethiopia can, similarly, reinforce any strategy that keeps its economic and legal interest. However, liberalization in this mode requires the movement of people and labor asking good labor standards and that will require amendment of the laws of Ethiopia.¹⁶²

This mode can have three scenarios. These are fully allowing foreigners to supply financial services while they are in Ethiopia, denying natural persons to provide financial services while they are in Ethiopia, and allowing conditional liberalization. Ethiopian current financial laws and practices allow foreign expertise to provide technical services in exceptional cases and falls in the third scenario (see section 2.3.1). However, the presence of intra-corporate transferees should also be allowed for a medium term in order for them to work in the joint venture and deliver financial services. Besides the temporary presence of these types of natural persons is recommendable to enable intra-corporate transfer of knowledge. The temporary stay of business visitors to prepare the establishment of a commercial presence of a financial service provider should also be open.¹⁶³ Commitments regarding the temporary presence of contractual service suppliers should be considered in particular for auxiliary financial services. However, contractual service suppliers for basic financial services are largely irrelevant. Besides, all the above can be limited with different time scales. Having the impact of LDCs' accession to the WTO on the four modes of financial service supply as a lesson for Ethiopia, the following can be concluded.

The most limited commitments have been made regarding cross-border supply while most countries scheduled far-reaching commitments in service supply through commercial presence.¹⁶⁴ This could be explained by the importance of transnational capital flows and acceding states' concern about currency crises. On the other hand, with the exception of Nepal, Mode 2 has been fully liberalized by most countries across the board. Regarding the presence of natural persons to supply financial services, most states have not made specific

¹⁶² Kassahun(2012) p.217

¹⁶³ Stern(2007) p.140

¹⁶⁴ Bienen(2014) p.22

commitments. In the horizontal sections, generally, the presence of natural persons is left unbound with a number of exceptions for the temporary presence of certain categories of business visitors.¹⁶⁵ Moreover, market access commitments are far more limited than national treatment commitments. For instance, under mode 3 most countries have eliminated virtually all limitations on national treatment.

Considering the practicability, economic advantage and risks associated in liberalizing the four modes of financial service supply for Ethiopia, the best combination of alternatives for all stakeholders would be; Conditional liberalization of cross border supply in explicit cases; fully opening mode 2; allowing the commercial presence of foreigners through branches, subsidy or equity participation; and conditional liberalization of the provision of financial services by natural persons. Besides, conditions like progressive equity participation, shares not more than 49% or allowing only branches of highly ranked Foreign FIs can be attached.

3.4 Cross-cutting issues

As discussed above (under section 3.3) strategic negotiation and proper assessment of commitment scenarios are vital for Ethiopia to maximize the benefits of acceding to the WTO in general and for the advancement of the financial service sector in particular. However, accession to the WTO alone is not the only answer for existing problems in the financial service sector. It is equally important for the GOE to deal with the following issues. These issues are crucial even if Ethiopia failed to join the WTO or whatever commitment scenarios it might achieve from its accession negotiations.

3.4.1 Let the NBE focus on regulatory tasks

According to the GATS Article I (3), services supplied in the exercise of governmental authority are not recognized as such. In the case of Ethiopia, the activities of central banks like carrying out monetary or exchange rate policies are excluded. However, this exclusion does not include services that are supplied either on a commercial basis or in competition

¹⁶⁵ Stern(2007) p.xvi

with service supplier(s). Therefore, the NBE's regulatory and macroeconomic functions (see section 2.3.2) will fall under the above Article while its commercial activities do not.¹⁶⁶

From economic point of view it is advisable to split the central and commercial banking roles of the NBE and to focus on the former. This is because the bank lacks the necessary resources to do both and the main problem of Ethiopian financial service sector is not lack of public FIs but the lack of information, competition and efficient regulation. Ethiopia has the third-highest public investment-to-GDP ratio in the world and the sixth-lowest private-investment-to-GDP ratio.¹⁶⁷ If Ethiopia aspires sustainable development, it must involve the private sector and that cannot be achieved without a strong central bank. Besides, if Ethiopia joins the WTO, these difficulties will get worse and hence the NBE should focus on how to solve those problems than direct commercial involvement.¹⁶⁸

Looking at other challenges that the NBE needs to address, we have inflation in the first place. The bank has pursued tight monetary policy focusing on strengthening the domestic resource mobilization but the problem has gotten worse.¹⁶⁹ Moreover, Ethiopia has a fiscal deficit of 2% of GDP and foreign exchange reserves shortage for almost two months' of import coverage. Meanwhile the stock of external debt as a ratio of GDP has reached 24.3%.¹⁷⁰ Ethiopian FIs should also play a leading role in adopting modern technologies to be able to bring their products and services as near as the hands of their customers, and this requires the initiative and leadership of the NBE.¹⁷¹ If the NBE focuses on its regulatory role with all its resources then it will be in a better position to deal with the above mentioned challenges.

¹⁶⁶ Kassahun(2012) p.231

¹⁶⁷ Geiger(2013) P.14

¹⁶⁸ Bezabeh(2014) p.32

¹⁶⁹ IMF(2014) p.5

¹⁷⁰ NBE Quarterly Bulletin(2014) p.33

¹⁷¹ Asegedew(2013) p.24

3.4.2 Addressing corruption

Combating corruption is another challenge for the growth of Ethiopian financial sector.¹⁷² Corruption perceptions index that measures public corruption ranked Ethiopia 111 out of 175 countries in 2013. The Ministry of Justice and the Federal Ethics and Anti-Corruption Commission are charged with combating corruption and since its establishment the Commission has arrested dozens of officials including managers of the Privatization Agency, Ethiopian Telecommunications Corporation, NBE, CBE, and Ethiopian Revenue and Customs Authority.¹⁷³ Clearly, there is a lot to be done by the GOE in this regard especially in relation to mode 2 financial service supply by foreign FIs (see section 3.3.2).

3.4.3 Proper sequencing of measures

From the experience of DCs in the WTO appropriate sequencing of reforms is essential.¹⁷⁴ For instance, despite extensive financial sector reforms, Sub-Sahara African financial systems faced serious inefficiency.¹⁷⁵ Countries that strengthened the supervisory and regulatory framework prior to liberalization succeeded far better than those that liberalized first.¹⁷⁶ Where prudential regulation was weak, FIs became over exposed to high risks and collapsed while countries with good macroeconomic policies and stabilization programs in place achieved more success.¹⁷⁷ Simply, achieving macroeconomic stability and strengthening financial sector regulation are intertwined processes with financial liberalization.¹⁷⁸ For instance, capital controls should be relaxed only after the financial sector reforms and effective regulatory capacities are in place.¹⁷⁹ Service sector liberalization and domestic regulatory reform must go forward in a parallel and unified path so that liberalization does not occur faster than the necessary regulatory reform in service sectors that are susceptible to specific types of market failure. Thus, the Ethiopian government is expected

¹⁷² Adrian(2014) p.17

¹⁷³ US Department of State(2014) p.12

¹⁷⁴ Cattaneo(2010) p.1

¹⁷⁵ Allen(2011) p.33

¹⁷⁶ Bezabeh(2014) p.36

¹⁷⁷ Ageba(2008) p.9

¹⁷⁸ Sáez(2010) p.10

¹⁷⁹ Ageba(2008) pp.18-19

to set appropriate sequencing and moderating infrastructure parallel to market liberalization efforts.¹⁸⁰

3.4.4 Utilize regional integration, BTAs and GSPs

WTO is only one option and opportunity for members without precluding other alternatives and privileges. For instance, regional integration among DCs, which can serve as a learning stage of weighing the benefits and costs of multilateral integration, is another alternative for Ethiopia.¹⁸¹ It can avoid the adverse effects of integration by restricting the involvement of non-members.¹⁸² Promoting the exchange of cultures and civilization, peace and security and creating economies of scale via market access opportunities are some of its benefits. Moreover, improving the supervision and regional laws that govern financial activities among states with the same level of development and common vision is easier than at multilateral level especially for states with less bargaining power.¹⁸³ It is also more feasible for Ethiopian FIs to create comparative advantage at regional level as they can compete better with institutions that are situated in similar circumstances.¹⁸⁴

However, in reality, financial service trade among DCs have more constraints than trade among developing and developed countries, and five times more barriers than trade among developed countries.¹⁸⁵ Financial service trade accounted only for 6% of all trade on merchandise and 10% of all trade in services globally.¹⁸⁶ Poor infrastructure, lack of technology and know-how, poor regulatory and institutional framework, macro-economic instability, lack of currency convertibility, lack of political commitment and corruption are major causes for such weak regional trade relations among DCs. Large size of the public sector, political instability and conflicts, lack of good governance are other setbacks.¹⁸⁷

¹⁸⁰ Kassahun(2012) p.219

¹⁸¹Ghebregergs(2013) p.16

¹⁸² Id, p.10

¹⁸³ Id, p.5

¹⁸⁴ Id, pp.36-37

¹⁸⁵ Id, p.6

¹⁸⁶ Ibid

¹⁸⁷ Ghebregergs(2013) p.8

In particular, Ethiopia's financial service export is limited. Looking at Ethiopian trade partners Europe takes the lead while Africa is the third.¹⁸⁸ Similarly inside COMESA, Ethiopia stood 8th in exports and 10th in imports and this shows its poor link and limited use of regional trade arrangements.¹⁸⁹ This fact is worse when it comes to the financial service supply where Africa is the least connected and Ethiopia is the most closed. Based on these facts, Regional integration in Africa can neither serve as a pretext to deny multilateral liberalization nor is enough in itself. Therefore, the GOE should make more effort to utilize regional opportunities.

BTAs and GSP are other options or opportunities of Ethiopia but the associated problem is that big powers use these mechanisms to exert the pressure of their trading interests that cannot be achieved multilaterally. Besides, BTAs are mostly conditional and that goes beyond trade interests and are more favorable for developed states as DCs have weak bargaining power. For instance, DCs committed more FTAs with developed countries when much of their trade in manufactured goods enters rich-country markets with duty-free GSPs.¹⁹⁰ Moreover, GSPs, which are meant to help LDCs, are not always benevolent and easy to squeeze their juice. This is because, first, the beneficiaries are unable to match the trading benefits of donors.¹⁹¹ Second, there are many beneficiaries leading to trade divisions and declining preference margins. Third, donors often attach side conditions that are trade unrelated and their implementation create substantial element of reciprocity.¹⁹² Fourth, GSPs are uncertain and temporary that can be unilaterally modified or revoked at anytime. Therefore, the GOE should continue an elegant use of GSPs and BTAs regardless of its accession to the WTO.

¹⁸⁸ Europe is 25% and Africa 18% export destination while Europe 53% and Africa 6% import origin for Ethiopia.

¹⁸⁹ Ghebregers(2013) p.31

¹⁹⁰ Gibbs(2007) p.55

¹⁹¹ Herz(2010) p.5

¹⁹² Persson(2013) p.14

3.4.5 Encourage competition

If Ethiopian FIs can be supported by the gymnastics of competition- consumers' best friend- the financial system would be stronger and more resilient to shocks. Here, relaxing entry requirements for FIs, reducing bureaucratic hurdles and creating efficient legal framework are important. Furthermore, having effective competition policy to reduce concentration and incontestability is crucial. There is also a need to strengthen the supervisory authority, improve the quality of financial information, and launch capital markets to give additional options of investment for savers.¹⁹³ That is why the IMF mission that visited Ethiopia on June 2014 stressed on the need for encouraging the private sector and improving competition, comprehensive financial information and reduction of public borrowing from domestic sources.¹⁹⁴

From experience, privatization in DCs is successful in promoting competition, increasing productivity, satisfying consumer needs and achieving economic growth.¹⁹⁵ The same is true for financial sector openness.¹⁹⁶ The key elements of financial openness are domestic market competition, foreign ownership, and limited capital controls, all of which are lacking in Ethiopia at present.¹⁹⁷ The inefficiency of Ethiopian public FIs, restrictive regulatory framework and prohibition of foreign entry in the financial service activities are offsetting the positive effects of financial intermediation and the growth of the sector. Therefore, to achieve the objectives of financial liberalization in Ethiopia, improving competition and continuation of liberalization tasks is required including calculated journey to the WTO.

3.4.6 Involve the private sector

One of the main reasons for the GOE's reluctance to join the WTO is the potential danger the domestic private sector might face (infant industry argument). However, the private sector has not been properly involved in the accession process (see section 1.2). Besides,

¹⁹³ Eshete(2013) p.186

¹⁹⁴ Salah(2014) p.5 and IMF(2014) p.16

¹⁹⁵ Kiyota(2007) p.11

¹⁹⁶ Bezabeh(2014) p.35

¹⁹⁷ Kiyota(2007) p.10

the private sector does not share all the GOE's fear towards financial sector liberalization. According to a study made by ECCSA, all Ethiopian domestic banks and insurances agree to the full opening of the Mode 2 with capital controls and the opening of the Mode 4 with qualification-requirements and limits on the number of employees. Their positions vary regarding cross-border supply of financial services and commercial presence. Majority of them agree to the opening of Mode 1 with domestic regulation and in the areas where they do not operate.¹⁹⁸ They are also interested in the opening of mode 3 in areas where they do not operate with domestic regulation and a transitional period of 5-10 years. Most of them agree to the requirement of joint venture with a maximum of 49% foreign equity participation and foreign-domestic management mix in proportion to capital contribution.¹⁹⁹ Some of them agree to the opening of conditional green-field investment. Similarly, being unhappy about the current performance of Ethiopian financial service sector, several customers believe that allowing the entry of foreign competitors into the Ethiopian market along with building the capacities of domestic FIs can enhance the competition and quality of the sector.²⁰⁰ Therefore, Ethiopian FIs and consumers are more or less positive towards financial liberalization and the GOE must advocate their interest in its negotiation.

¹⁹⁸ ECCSA(2013) pp.33-34

¹⁹⁹ Ibid

²⁰⁰ Ibid

4 Conclusions

The GOE has been cautious towards financial liberalization although reforms like privatization has taken place since 1992, which increased the number of FIs, their branches, and financial products-portfolio.²⁰¹ However, the sector, which is reserved for domestic investors, is still at the early stage of development.²⁰² The state is acceding to the WTO since 2003 and the liberalization of the financial service sector has been the most sensitive part for the GOE. Liberalization in the context of GATS should, of course, be analyzed considering how it will fit into Ethiopian overall reality, development objectives, and its impact on different modes of financial service supply. This is because the result of such reforms does not depend on the mere existence of the process but on how it fits with such legal and economic needs.

Following WTO accession all members have allowed foreign FIs' entry, which mostly led to an increased competition, better intermediation and improved transfer of technology. However, not all members allowed 100% foreign ownership and foreign FIs to freely operate in capital movements and foreign currencies. In some cases, poor macroeconomic performance, weak policy environment, political instability and corruption had prevented such positive outcomes.²⁰³ Basically, WTO offers both opportunities and risks. It is up to members to make the best out of it by combining strategies of negotiation, and addressing domestic regulatory and related problems. Accession to the WTO will change the rules of business making by strengthening the forces of the market²⁰⁴ and that is a good opportunity for Ethiopia who stood 125th out of 189 countries based on ease of doing business 2014 index.²⁰⁵

Liberalization commitment schedules have tended to become more complex over time. However, there is no common policy regarding the extent of commitments in the financial

²⁰¹ Geda(2006) p.29

²⁰² MOFED-PRSP(2002) p.110

²⁰³ Ageba(2008) p.10

²⁰⁴ Bienen(2009) P.12

²⁰⁵ The World Bank(2014) p.3

sub-sectors and different countries responded differently towards external pressure. The special treatment scheme for LDCs has not been applied practically in accession negotiations.²⁰⁶ However, Ethiopia should try to benefit from such flexibilities.

Ethiopian financial sector, which is dominated by the banking industry and public FIs is one of the least developed in the world. The regulatory body i.e. NBE is inefficient and has set inhibitive requirements on FIs during establishment and operation. Lack of capital and money markets, limited accessibility in rural areas and shortage of products portfolio are other problems. The sector is totally closed from commercial presence of foreign FIs in mode 3, slightly open in mode 1 and 4, where as there is no clear regulation regarding mode 2.

Looking at the Ethiopian accession negotiation and potential commitment scenarios for the financial service sector, commercial presence and cross-border supply are the focal issues.

Conditional liberalization of mode 1; full liberalization of mode 2; foreign FIs' commercial presence in Ethiopia through branches, equity participation and/or subsidiaries in mode 3; and allowing conditional presence of foreign natural persons in Ethiopia to deliver financial services in mode 4 seems the most feasible combination of scenarios that allows Ethiopia to take advantage of the liberalization process while simultaneously minimizing the spill-over risks and challenges.

Finally, acceding to the WTO alone will not enable Ethiopia to achieve growth in the financial service sector or economically. Therefore, the GOE should equally pay attention to solving domestic problems of regulation, corruption and lack of competition. It should also exploit other alternatives and opportunities like RTAs, BTAs and GSPs.

²⁰⁶Ageba(2008) p.11

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